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RUEHNE/AMEMBASSY NEW DELHI 2310  
RUEHKA/AMEMBASSY DHAKA 1090  
RUEHIL/AMEMBASSY ISLAMABAD 8091  
RUEHKT/AMEMBASSY KATHMANDU 6289  
RUEHCG/AMCONSUL CHENNAI 8716  
RUEHLMC/MILLENNIUM CHALLENGE CORPORATION

UNCLAS SECTION 01 OF 03 COLOMBO 000922

SENSITIVE

SIPDIS

STATE FOR SCA/INS AND EEB/IFD/OMA  
STATE PASS USTR FOR DARLA BROWN AND ADINA ADLER  
DOL/ILAB FOR TINA MCCARTER  
MCC FOR S. GROFF, D. TETER, D. NASSIRY AND E. BURKE  
TREASURY FOR LESLIE HULL

E.O 12958: N/A

TAGS: [ECON](#) [EFIN](#) [ETRD](#) [KMCA](#) [CE](#)

SUBJECT: SRI LANKA: ECONOMY GROWING, BUT PROBLEMS REMAIN

REF: (A) COLOMBO 821

(B) COLOMBO 730

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¶1. (U) Summary: Despite the war, Sri Lanka's GDP grew by a respectable 6.6% in the first half of 2008. The Sri Lankan rupee (SLR) remains relatively steady due to Central Bank intervention. Other key macro indicators weakened. Inflation remains high at 24.3%. The trade deficit expanded sharply due to high oil prices. The Central Bank increased foreign borrowing to shore up reserves lost on the trade front. The Colombo Stock Exchange fell 15% from January to September, due to domestic concerns and as well as recent Wall Street woes. Despite these concerns, business confidence, as indicated by a monthly Nielsen survey, surged to an 18 month high.

#### 6.6% GDP GROWTH IN FIRST HALF OF 2008

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¶2. (U) According to the Department of Census and Statistics, Sri Lanka's economy expanded by a strong 7% in the second quarter 2008 against 6.4% in the second quarter 2007. This brought GDP growth for the first half of 2008 to 6.6%, compared with 6.3% in the first half of 2007. The Central Bank's published expected growth for 2008 is 7%. The Bank will likely revise its GDP growth forecast for 2008 slightly downward. The Asian Development Bank recently forecasted 6% annual GDP growth in both 2008 and 2009.

¶3. (U) In the second quarter, agriculture grew by over 7% boosted due to increased rice production. (Note: The agricultural sector contributes approximately 12% of GDP.) 2007 witnessed a sharp drop in rice paddy cultivation due to the conflict in the East. In 2008, good rains, the return of relative peace in the eastern province, and subsidized fertilizer helped to spur a recovery in rice production. Services, the largest economic sector, grew by 6.9%. In particular, telecommunications continued its strong expansion, recording a 23% growth. Other key contributors to services sector expansion were trade, transport, ports and banking. Government services, which account for about 8% of GDP, grew by 7%. Growth in the tourism sector was flat as the sector failed to recover from its sharp decline in 2007. Tourist arrivals decreased by 4.3% in the first seven months. Manufacturing sector growth slowed to 4.9% in 2Q2008 from 7.1% in 2Q2007. Textiles and apparel sector recorded a

marginal increase of 0.1% compared with 8.2% growth over the same period in 2007.

#### TRADE DEFICIT WIDENS SHARPLY

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14. (U) According to the latest statistics, in the first seven months of 2008 Sri Lanka's trade deficit expanded an exceptional 88% to \$3.5 billion. Exports increased by 12% to \$4.7 billion while imports swelled by 35% to \$8.2 billion. On the import side, oil imports rose 67% to \$2 billion from \$1.25 billion, food imports increased 60% to \$957 million, and fertilizer imports also demonstrated a significant increase. Capital goods, such as building material and machinery, rose during this period.

15. (U) Tea, which is experiencing a surge in prices, drove the export growth. Tea exports earnings swelled by over 40%. Garments, Sri Lanka's largest export category, rose by 4%. Other manufactured exports also rose by about 4%. Exports to the United States, Sri Lanka's second-largest market, recorded a 5.4% decline on top of a 3.7% decline in 2007. Exports to the EU, which enter duty free under the EU's GSP-Plus Program, increased.

#### REMITTANCES CONTINUE TO INCREASE

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16. (U) Remittances, Sri Lanka's second largest source of foreign exchange after garment exports, increased by 20% to \$1.7 billion in the first seven months of 2008. Net private remittances financed over 40% of the trade deficit in the first half of 2008, compared with 70% in 2007. The balance was primarily financed through government borrowings.

INFLATION 24.3% IN SEPTEMBER 2008;

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#### CENTRAL BANK CLAIMS SUCCESS ON MONETARY POLICY

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17. (SBU) Inflation, as measured by the New Colombo Consumer Price Index (CCPI-N), was 24.3% in September (year-on-year). Inflation, which hit a record 28.2% earlier this year due to both demand and supply side pressures, has eased somewhat since then. The Central Bank has followed a tight monetary policy since January in an attempt to reign in inflation. The Central Bank reports that its monetary tightening has worked well to control money supply. Food prices, which skyrocketed in the first half of 2008 due to a shortage, are easing due to increased production locally and the fall in the rate of global food price increases. In a statement issued September 30, the Central Bank said "Supported by continued containment of demand pressures as well as improvements on the supply side, inflation is expected to moderate further during the months ahead." Whether that is true remains to be seen. Some allege that the new CCPI index does not truly reflect inflation as it removed an entire sub group (alcohol and tobacco) from review. The government statistics office was also caught spreading some price increases across more than one month.

18. (U) On September 30, the Central Bank relaxed its monetary policy in response to the global financial crisis. The bank eased conditions for financial institution access to Central Bank financing in an effort to improve liquidity. As a result, commercial bank and primary dealers' access to the Central Bank's discount window increased to six times per year (vice three times per year). The bank expects the move to contain volatility in interest rates.

#### RUPEE STEADY AGAINST THE DOLLAR BUT APPRECIATES ELSEWHERE

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19. (U) The Sri Lankan Rupee has been steady against the U.S. dollar in 2008; it is currently trading around 108 against the dollar. However, since January the rupee appreciated 9% against the sterling, 4% against the Euro, and 15% against the Indian Rupee. Exporters continue to complain about the rupee's appreciation amid

high inflation and the growing current account deficit. They blame Central Bank intervention for the appreciation, as the Central Bank increased short term foreign borrowing to shore up reserves. (Note: The Bank also relaxed foreign investment in government bond markets, and commercial banks are now permitted to accept deposits from foreigners.) The Central Bank disagrees and maintains the exchange rate is determined through market forces.

¶10. (U) The Bank, in particular the Governor, continues to urge businesses to improve productivity to stay competitive rather than counting on a depreciating currency. Reiterating the Central Bank's exchange rate policy, the Governor recently stated that "Under the floating rate regime, the Sri Lankan currency can no longer be regarded as a steadily and continuously depreciating currency...The stabilization of the SL rupee utmost underlines the need for the export and import competing sectors to focus more on productivity improvements and market access in order to maintain external competitiveness. Instead of waiting for the exchange rate to depreciate and then for our businesses to become competitive, it's time for all of us to improve our productivity in whatever manner we can."

#### POOR STOCK MARKET PERFORMANCE

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¶11. (U) The Colombo Stock Exchange (CSE) is performing poorly in ¶2008. The escalation of war in the north and bomb blasts in and around Colombo are main contributors to the CSE's weak performance. The failures on Wall Street contributed to sharp declines in September. The market was also affected by high nominal interest rates, falling profits of Telecom giant Dialog and an August 2008 Supreme Court judgment against John Keells Holdings (JKH), Sri Lanka's largest blue chip conglomerate (see reftel B). CSE's all share price index fell 15 percent (400 points) between January 1 and September 30. The index lost 6% prior to the U.S. stock market failures in mid-September; since then it lost a further 9%. The

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downturn wiped Rs 125 billion (over USD 1.1 billion) off CSE's market capitalization in 2008. As of September 30, the All Share Price Index (ASPI) stood at 2,142 points, the lowest level since the resumption of war in April 2006. Performance in early October remains weak.

#### AND YET, BUSINESS CONFIDENCE INDEX SURGES

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¶12. (U) The Lanka Monthly Digest-ACNielsen Business Confidence Index (BCI), which surveys 100 senior top executives in Colombo, surged to an 18-month high in September. Nearly one third of the respondents to the poll have said the economy will improve, the most confident they have been about the economy since October 2006. The Lanka Monthly Digest, quoting pollsters, said expectations of an end to the war in the not too distant future and the downward slide in oil prices may be among the principal reasons for the sudden surge in confidence in the last two months. (Note: The survey took place in early September, prior to the Wall Street failures.)

#### COMMENT

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¶13. (SBU) Despite the government's efforts to tout its tight monetary policy, economic analysts warn that the government's ongoing attempts to keep the rupee pegged to the dollar are misguided and damaging, and will ultimately undermine efforts to date. Increasing efforts by the military to push forward against the LTTE in the North could also put additional strain on government resources, forcing tough policy choices if the President insists on additional revenues in the next budget to fund the war effort. The government's new budget is scheduled to be presented on November 6.